



ISSUE PAPER

# Simplify the Excise Tax on Private Foundations (S. 676 / H.R. 4090)

**Position:** The Council on Foundations supports simplification of the private foundation excise tax on net investment income to a flat rate that is revenue neutral.

## U.S. Senate

Introduced:

Charles Schumer (D-NY)

Carl Levin (D-MI)

Debbie Stabenow (D-MI)

Co-sponsors:

Mark Begich (D-AK)

Richard Burr (R-NC)

Saxby Chambliss (R-GA)

Johnny Isakson (R-GA)

Lisa Murkowski (R-AK)

## U.S. House of Representatives

Introduced:

Danny K. Davis (D-IL7)

John Lewis (D-GA5)

Patrick J. Tiberi (R-OH12)

Co-sponsors:

Bob Etheridge (D-NC02)

Jesse L. Jackson, Jr. (D-IL02)

Sander M. Levin (D-MI12)

Tim Murphy (R-PA18)

Gary Peters (D-MI09)

Fred Upton (R-MI6)

Don Young (R-AK At Large)

## Revenue Estimate

Revenue Neutral

## Current Law

Internal Revenue Code section 4940 requires private foundations to pay an annual excise tax equal to 2 percent of their net investment income. However, the tax is reduced to 1 percent in any year in which a foundation's distributions (measured as a percentage of assets) exceeds the average payout rate of the foundation calculated over the preceding five years. Not only must the current distribution percentage exceed the previous five-year average, but it must do so by an amount at least as much as the 1% tax savings the foundation will enjoy. This "maintenance of effort test" was intended to ensure that the tax savings be used for additional charitable expenditures and not just "pocketed" by the foundation. Congress stated upon enactment of the excise tax that it was meant to fund IRS operations relating to the non-profit sector. Whether or not a foundation qualifies for the 1% reduction, it is still legally required to make annual minimum distributions (equal to approximately 5% of assets) under Internal Revenue Code section 4942.

## Proposal

Simplify the excise tax on investment income by eliminating the two-tiered rate and replacing it with a flat revenue-neutral rate, estimated to be 1.32 percent in a study by Cambridge Associates. Though most foundations would prefer a flat 1 percent rate they acknowledge that the revenue loss (\$1.87 billion over ten years) of a 1 percent proposal would likely prevent it from being enacted. Both S. 676 and H.R. 4090 set the revenue-neutral rate at 1.32 percent, although that number could change if the Joint Committee on Taxation (JCT) determines that a different rate is needed to achieve revenue neutrality.

## Rationale

**Disincentive Effect:** The current two-tier system actually serves as a disincentive to increased giving, especially in times of crisis or economic turmoil. A 2006 study by Professors Richard Sansing of Dartmouth and Robert Yetman of the University of California found that current law can have "countervailing effects on foundation behavior." The study noted that current law "creates a tax-induced incentive" to reduce contributions in "difficult economic times" such as we are now experiencing "because a high distribution this year makes it more difficult to qualify for the lower rate during the next 5 years." That is particularly true if, as in the recent past, asset values have declined sharply, thus reducing the denominator by which payout rates are calculated. In such instances, foundations subject themselves to higher tax rates in future years unless they reduce the dollar amount of their giving at a time when such support is most needed.

**Penalizing Extraordinary Giving:** Any increase in annual giving, relative to the foundation's assets, will necessarily increase the five-year average payout. If the increase is significant, the average payout-rate may be so high that it isn't sustainable without eroding the value of the endowment relative to inflation. Significant increased giving can occur when a foundation seeks to respond to an extraordinary event, such as Hurricane Katrina, the September 11<sup>th</sup> attacks or another crisis. An increase in giving relative to endowment can also occur where grantmaking remains stable even though assets have declined. In today's economy, this concern is particularly acute. Many private foundations in America are seeking to maintain prior grant commitments, despite losing 30 percent of their endowment's value in 2008. But honoring those commitments will cause their payout rates to increase by as much as two to three percent and penalize them with higher taxes when their grants return to more sustainable levels.

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(Over)*

## Rationale (continued)

Simplification: A flat, excise tax rate will simplify tax planning for many foundations, especially smaller foundations. The calculation of distributions necessary to qualify for the reduced tax is a moving target because it depends on the 12-month average asset balance of the foundation, which can't be known until the end of the year, and on the foundation's investment income, which may not be fully known until well into the following year. As such, foundations base their annual budget on assumptions about the market and community needs. A dramatic change in either (or both) can change the target significantly. Foundations spend time and money every year making sure the amount spent by the end of year is neither too high nor too low. This is time and money that could be spent on grantees and programs rather than accountants and lawyers.

Tax Policy: The Council has long supported reduction or elimination of the section 4940 tax because it has never been used as it was originally intended -- to pay for IRS enforcement and oversight of the nonprofit sector. Each year the government receives substantially more from the excise tax than it spends on sector enforcement and oversight.

## Revenue Neutrality

Both S. 676 and H.R. 4090 would impose a single excise tax rate at a level meant to achieve revenue neutrality. The rate of 1.32% specified by the bill is based on a study commissioned by private foundations that determined that rate would be revenue neutral. However, the bill's sponsors contemplate that the proposed excise tax rate would change if the Joint Committee on Taxation determined that a different rate is needed to achieve revenue neutrality.

Though foundations would welcome a flat rate of 1%, they recognize that fiscal realities make problematic any tax code change which would result in a loss of revenue. For that reason, and because the principal problems presented by the current two-tiered excise tax rate do not relate to revenue, the Council on Foundations supports a single, revenue neutral rate.

## Opposition

Tax Increase: Some foundations are able to successfully manage their distributions in order to qualify for the 1% rate year after year. For those foundations, any rate above 1 percent will be a tax increase. For very large foundations, this can mean millions of dollars in increased taxes. Even for smaller foundations where the actual dollar amount may not be as high, they would prefer to spend it on grantees in their community, rather than on taxes.

Incentive Effect: Some Members and staff continue to believe that the two-tiered rate structure incentivizes increased giving above and beyond the minimum distribution required by law. While supportive of the idea of simplification, they believe any proposal to amend the structure should retain incentives for foundations to annually increase their giving.

## Status of Legislation

On March 24, 2009, Senator Charles Schumer (D-NY), along with Senators Carl Levin and Debbie Stabenow of Michigan, introduced a private foundation excise tax bill (S.676). This proposal would amend the IRS Act of 1986 to remove the current two-tiered excise tax imposed on private foundations and replace it with a flat rate at 1.32 percent, which is expected to be a revenue-neutral level. On November 17, 2009, Representative Danny Davis (D-IL7) along with Representatives John Lewis (D-GA5) and Patrick Tiberi (R-OH12) introduced a House companion excise tax bill, HR. 4090. That proposal would similarly flatten the rate to 1.32 percent but would do so for a temporary period of five years to allow a careful study of the effects of the flattened rate on foundation giving.